March 6, 2003

To: All Commodity Pool Operators
Attention: Chief Financial Officer

Subject: 2002 Annual Reports for Commodity Pools

This is the fifth annual letter that the Division of Clearing and Intermediate Oversight ("DCIO")[1] of the Commodity Futures Trading Commission ("CFTC" or "Commission") is issuing to registered commodity pool operators ("CPOs") to share the results of DCIO's experience reviewing prior years' annual pool reports. These letters are intended to assist CPOs and their independent accountants in complying with Part 4 of the Commission's regulations under the Commodity Exchange Act ("CEAct") in connection with the preparation and filing of a pool's annual financial report. Previous letters are available at the Commission's website: http://www.cftc.gov/tm/tmcompliance.htm.

The letter first highlights common deficiencies noted during the review of the 2001 annual reports, then discusses several accounting and reporting topics, and finally notes several regulatory changes and proposed changes. Because many of the deficiencies noted occur in reports for offshore pools, it will be helpful for CPOs to share this letter with offshore correspondents and local auditors.

I. Common Deficiencies

In order to avoid some of the most common and easily remedied deficiencies, CPOs should do the following:

- File one copy of the annual report with the National Futures Association ("NFA") at the address set forth in Attachment A below. As discussed in Section IX below, *CPOs are no longer required to file copies of any such reports with the CFTC.*
- File the annual report as soon as possible, but no later than the due date. For pools with a December 31, 2002 year-end, the due date is Monday, March 31, 2003 (unless an extension of time has been requested and granted). CPOs operating a "fund-of-funds" pool should review the streamlined procedures described in Regulation 4.22(f)(2) for claiming an extension of the due date (this topic is discussed below).
- Include a signed oath or affirmation, as required by Regulation 4.22(h), with each copy of the annual report filed with NFA and all pool participants. This continues to be a common deficiency in annual financial report filings. Binding the oath as part of the report package or attaching it to the cover page is a best practice followed by a number of CPOs.

[1] As of July 1, 2002, a reorganization of Commission staff became effective. For purposes of this letter, the term "Division" includes the Division of Clearing and Intermediary Oversight and its predecessor, the Division of Trading and Markets, as the context requires.

- If the pool is operating under the exemptions granted in Regulation 4.7 or Regulation 4.12, those regulations require that a notation of that fact be made on the cover page of the report.

- Report special allocations of partnership equity as required by CFTC Interpretive Letter 94-3, *Special Allocations of Investment Partnership Equity* (CCH ¶25943). This document is available on the Commission website at www.cftc.gov/tm/94-03.htm.

- Net Asset Value:
  - For unitized pools, include information concerning net asset value per outstanding participation unit in the pool as of the end of each of the pool's two preceding years.
  - For non-unitized pools, provide to each participant the total value of that participant's interest or share in the pool as of the end of each of the pool's two preceding fiscal years. Please provide a schedule listing each participant's balances for those years. A code for each participant may be used in lieu of the participant's name. *Of course, participants should not receive financial information concerning other participants*.

- If the annual report is unaudited (pursuant to the exemption of Rule 4.7):
  - The pool operator must make a statement to that effect on the cover page of each report and state that a certified audit will be provided on request of a majority of the units of participation in the pool who are unaffiliated with the commodity pool operator.
  - The annual report must nonetheless be presented and computed in accordance with generally accepted accounting principles consistently applied ("GAAP"). This includes the requirements of AICPA statement of position ("SOP") 95-2, as amended by SOP 01-1, and CFTC Interpretative Letter 94-3.
  - The annual report must include appropriate footnote disclosures.

II. Applicability of GAAP to Commodity Pools' Annual Financial Statements

In reviewing prior years' annual reports, DCIO has noted instances where CPOs filed pool financial statements that failed to comply with GAAP. Commission Rules 4.22(d), 4.12(b)(2)(iii)(B), and 4.7(b)(3)(ii) require that financial statements of pools be presented and computed in accordance with GAAP, including disclosing risk concentrations (e.g., market and credit risk) and related party transactions, and recognizing the impairment of investment values. Pools exempt from filing certified financial statements, such as pools qualifying under Regulation 4.7, must nonetheless compute and present their financial statements in accordance with GAAP. If a commodity pool's financial statements depart from GAAP, the CPO may be required to revise the pool's financial statements and send the revised statements to participants and NFA.

GAAP requires (Accounting Principles Board Opinion 22) that all significant accounting policies followed by an enterprise be disclosed in its financial statements. For commodity pools one of the most significant, if not the most significant, accounting policy is how fair values of investments are determined. Accordingly, CPOs are reminded that such disclosures are required and should quantify values arrived at by the valuation methods specified in the AICPA Audit and Accounting Guide, *Audits of Investment Companies* paragraphs 2.28 through 2.39.

III. Audit Opinion

Beginning with annual reports issued for fiscal years commencing after December 15, 2000, commodity pools were required to present condensed schedules of investments in accordance with GAAP. Audit opinions on some pools' financial statements took exception because CPOs failed to identify by name investments for which specific disclosure is required by GAAP. Since 2001 was the first year of such requirement, DCIO reminded CPOs filing certified annual reports with qualified audit opinions (and other CPOs filing annual reports that do not require an audit opinion) that they must comply fully with GAAP in 2002 reports.

The AICPA has initiated a task force to review certain issues concerning non-registered investment partnerships, including commodity pools, regarding the implementation of the AICPA Audit and Accounting Guide, *Audits of Investment Companies* and SOP 95-2. One of the issues the AICPA task force is considering is more meaningful disclosure for nonpublic investments. Any new SOP that would be adopted by the AICPA, however, is not expected to be finalized until after the filing deadlines for December 31, 2002 commodity pool annual reports.

DCIO also continues to be concerned with the level of disclosure regarding a pool's investments in other investment companies and believes that complete disclosure to the participants in a commodity pool requires that the pool's financial statements provide information about other funds to which the pool devotes significant portions of its capital ("major investee funds").[2] DCIO has long considered detailed income, fee and liquidity information for material investee pools and in total for all investee pools "material information," essential for full disclosure to participants. The objective is to allow participants to see the performance of the pool's major assets and the fees associated with these investments.

Over the past several years reporting of such information has improved significantly as a result of reports presenting the information using the illustration supplied with past letters. To maintain and to continue that level of disclosure, the illustration is included as Attachment B to this letter.

DCIO requires full disclosure in compliance with GAAP. Accordingly, pending the issuance of a new SOP by the AICPA, SOP 95-2 remains in effect and full compliance in commodity pool annual reports is expected. CPOs that fail to include the disclosures required by SOP 95-2 or the

---

[2] If a pool's investment in an investee fund is 10 percent or more of the pool's net assets, the investee fund is considered a "major investee fund." <u>See</u> Regulation 4.10(d)(5), 17 CFR 4.10(d)(5) (2002).

information set forth in Attachment B for major investee funds will be required to revise the pool's financial statements and to provide the revised statements to participants and NFA.

IV. Reporting Futures Transactions in a Summary Schedule of Investments

The AICPA task force also is considering how best to report derivative instruments, including futures contracts, in the financial statements of non-registered investment partnerships. Suggested guidelines are in the early stages of development at the date of this letter. Accordingly, CPOs are urged to consult with their auditors to devise the most meaningful disclosures for derivatives in their particular situations. The objective of such disclosures should be as stated in Paragraph 17 to ACIPA SOP 95-2: "Disclosures should provide financial statement users with information that aids decision making." FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information,* states in Paragraph 40 that, "the benefits of information may be increased by making it more understandable and, hence, useful to a wider circle of users."

V. Master-Feeder Structures

Paragraph 7.06 of the AICPA Audit and Accounting Guide, *Audits of Investment Companies*, permits nonpublic feeder pools either to follow the provisions of SOP 95-2 or to present a complete set of master financial statements with each feeder financial statement. CPOs who elect to present a complete set of master financial statements with each feeder financial statement are encouraged to bind the two reports together as a single document and to send it to the participants and the NFA. If that is not possible, an alternative would be to staple the back cover of the feeder annual report to the front cover of the master annual report for at least the copy filed with the NFA. This would help ensure that reports are reviewed as a complete unit.

VI. Extended Due Date for Fund-of-Funds Pools

Regulation 4.22(f)(2) simplifies the process for fund-of-funds pools to obtain extensions of time for filing annual reports. The rule permits a CPO to file a claim for an automatic extension of time to file a pool's annual report where the pool is invested in other collective investment vehicles, and the CPO's independent accountant cannot obtain the information necessary from the other collective investment vehicles such that the annual report for the pool cannot be filed within 90 days of its year-end. Fund-of-Funds with a December 31, 2002 year-end may obtain an additional 60 days, extending the due date to Friday, May 30, 2003, by filing the representations outlined in 4.22(f)(2).

Regulation 4.22(f)(1) permits a CPO to request an extension of time to file an annual report in the event the CPO finds that it cannot distribute the report within 90 calendar days after the end of the pool's fiscal year. By order dated December 18, 2002, the Commission delegated to NFA the authority to receive and process requests for extensions under Rule 4.22(f)(1) (the delegation is discussed below in Section IX). Accordingly, CPOs should send their requests to the NFA's

Chicago office at least 14 days before the deadline to be extended or should explain why doing so was impracticable.

Last year DCIO received many requests for filing extensions, especially from Rule 4.7 pools. DCIO is cognizant of the benefits of providing an audited financial report. However, these benefits must be weighed against the need for pool participants to obtain financial information in a timely manner so that they may make informed investment decisions. Delaying delivery of an annual report past mid-year (i.e., June 30 for a December 31 report) may well outweigh the advantage of having the annual report certified. Therefore, DCIO often denied the relief as requested due to the need for the dissemination of timely information and required the requesting CPO to file an unaudited report for the current year. The CPO may, if it chooses, later distribute a certified annual report to the participants.

VII. New Pools – Initial Annual Reports

In cases where a pool commences operations within three months of the end of its fiscal year, the Commission may grant an exemption to the requirement to file a certified annual report as of its initial fiscal year-end. As a condition to the exemption, the Commission may accept a non-certified annual report for the short-year and require the CPO to file a certified annual report as of the end of its second fiscal year-end, which must include an income statement for the period from its commencement of operations to the second fiscal year-end. For the full requirements for such an exemption, please contact Kevin Walek, Assistant Director, at kwalek@cftc.gov or (202) 418-5463 (not a toll-free number).

VIII. Final Annual Reports

When a pool ceases trading, the CPO must file a final report as required by Regulation 4.22(c). The final report should be in the same format and include the same information as the annual report, even if the final report is not for a full 12-month period. If the final distribution has not been made as of the balance sheet date, a subsequent event note to the financial statements should report the date on which all assets were subsequently, or are expected to be, distributed to the participants. A CPO should clearly state when it intends a report to be its final report. A legend on the cover of the report is an effective way to do so.

IX. Simplification for Filing Annual Reports, Extensions of Time and Certain Exemptions - Delegation Order to NFA

By order dated December 18, 2002, the CFTC delegated the primary responsibility for regulation of commodity pools, including review of annual reports, to the NFA. The Commission order authorizing NFA to review pool annual reports may be found at http://www.cftc.gov/foia/fedreg02/foi021218c.htm. *Accordingly, for fiscal years ending on or after December 31, 2002, CPOs need only file one copy of each pool report with the NFA at the address set forth in Attachment A.* CPOs are no longer required to file copies of any such reports with the Commission. However, annual reports must continue to comply with appropriate Commission rules.

In addition, applications for extensions of time to distribute annual reports and claims for exemptions, including those for offshore commodity pools in CFTC Advisory 18-96 (http://www.cftc.gov/tm/tmcpo-advi.htm) also should be filed only with the NFA. Any commodity pool related documents received by the Commission will be forwarded to the NFA.

X. Additional Relief from Registration as a Commodity Pool Operator –Advance Notice of Proposed Rulemaking

Over the past several years the Commission has received requests for additional exemptions from CPO registration based on such factors as investor criteria and the amount and purpose of commodity interest trading. In an Advance Notice of Proposed Rulemaking, published in the *Federal Register* on November 13, 2002, the Commission: (1) published two proposals it had received for additional CPO registration exemptions (one each from NFA and the Managed Funds Association) and (2) took temporary CPO registration no-action positions (based on investor criteria, amount of trading and a notice filed with the Commission and NFA claiming the relief).

The criteria of the temporary registration no-action relief for CPOs are that: (1) the pools for which a CPO claims the relief has as participants solely accredited investors, non-United States persons and insiders, such as knowledgeable employees; and (2) the notional value of each pool's commodity interest positions does not exceed one-half of the pool's NAV. *The temporary registration no-action relief remains in effect until the Commission takes final action on this rulemaking.* A copy of this *Federal Register* release is available at the Commission's website: http://www.cftc.gov/foia/fedreg02/foi021113a.htm.

In another Proposed Rulemaking, published in the *Federal Register* on October 28, 2002, the Commission: (1) proposed to expand the commodity interest trading permitted under the Rule 4.5 exclusion with an additional test: that the notional value of a qualifying entity's commodity interest positions does not exceed the pool's NAV and (2) took a temporary no-action position to permit Rule 4.5 eligible persons to take advantage of the proposed relief pending final action on the rulemaking. For additional details see http://www.cftc.gov/foia/fedreg02/foi021028a.htm.

The Commission currently is analyzing the comments it has received on these proposed actions.

XI. Anti-Money Laundering and Terrorist Financing

The International Money Laundering Act (AML) was enacted on October 26, 2001 as part of the USA Patriot Act. The focus of this new legislation is to identify and track entities and funds used for illegal purposes. It empowers the Department of the Treasury, in consultation with the Commission, to promulgate rules imposing obligations on, among others, CPOs.

Under the Patriot Act, persons who are or are required to be registered as futures commission merchants (FCMs), introducing brokers (IBs), commodity pool operators (CPOs), and commodity trading advisors (CTAs) are subject to new requirements for establishing AML programs, reporting suspicious activity, verifying the identity of customers, and dealing with certain types of accounts involving foreign persons. For details see the CFTC website at http://www.cftc.gov/cftc/cftcaml.htm.

XII. Conclusion

In addition to noting the issues discussed in this letter, CPOs and their accountants should be familiar with the AICPA Audit and Accounting Guide, *Audits of Investment Companies* and the AICPA Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*.

Additional information applicable to pools, such as exemptive, no-action, or interpretive letters from 1995 forward, is available at the Commission's website, http://www.cftc.gov/opa/opaletters.htm.

If you or your accountant have any questions on the foregoing, please feel free to contact the appropriate regional DCIO staff member listed in Attachment A to this letter.

Jane K. Thorpe
Director
Division of Clearing
and Intermediary Oversight

ATTACHMENT A

CFTC's DIVISION OF CLEARING

AND INTERMEDIARY OVERSIGHT: CONTACT DETAILS

Regional Offices and Contacts	Location of CPO's Principal Office
Eastern Region 140 Broadway, 19th Floor New York NY 10005-1146 Ronald A. Carletta Al Goll Phone: (646)-746-9726/9723 FAX: (646)-746-9937 E-Mail: rcarletta@cftc.gov agoll@cftc.gov	All states east of the Mississippi River, *except* Illinois, Indiana, Michigan, Ohio, and Wisconsin. Any location outside of the United States
Central Region 525 West Monroe Street Suite 1100 Chicago, IL 60661 John S. Dixon Phone: 312-596-0573/0581 FAX: 312-596-0713 E-Mail: jdixon@cftc.gov	Illinois, Indiana, Michigan, Ohio, and Wisconsin
Southwest Region 4900 Main Street Suite 721 Kansas City, MO 64112 Ralph L. White Phone: 816-931-9502 FAX: 816-931-9643 E-Mail: rwhite@cftc.gov	All states west of the Mississippi River

NFA CONTACT DETAILS

National Futures Association
Patricia Cushing
Compliance Department
200 West Madison 16th Floor
Chicago, IL 60606
Phone: 312-781-1300
FAX: 312-781-1467
website: http://www.nfa.futures.org/

ATTACHMENT B

ILLUSTRATION – FUND – OF – FUNDS DISCLOSURES

Note X. Investments

As of December 31, 2002, ABC Fund invested in other funds, none of which were related parties.

The following table summarizes ABC Fund's investments in other funds as of December 31, 2002. Funds in which ABC Fund invested 10% or more of its net assets are individually identified, while smaller investments in three other funds are aggregated. The management agreements of the investee funds provide for compensation to the managers in the form of fees ranging from 1% to 3% annually of net assets and performance incentive fees ranging from 5% to 25% of net profits earned.

Investment	% of ABC's Net Assets	Fair Value	Income (Loss)	Fees Mgnt	Fees Incentive	Redemptions Permitted
Hejmat Fund Ltd.	11.2	$ 500,000	$145,000	$ 5,200	$ 30,000	Quarterly
Carron Int'l Fund	10.7	475,000	118,000	4,800	24,000	Monthly
Marvelous Fund NV	10.1	450,000	(24,000)	4,500	0	Semi-Annual
Other funds:	10.8	480,485	18,221	5,500	3,500	Monthly-Annually
Total	42.8%	$1,905,485	$257,221	$20,000	$57,500	

An alternative illustrative table, for *unusual cases,* where the fee information cannot be obtained is shown below:

Investment	% of ABC's Net Assets	Fair Value	Income (Loss)	Fees Mgnt	Fees Incentive	Redemptions Permitted
Hejmat Fund Ltd.	11.2	$ 500,000	$145,000	$ 5,200	$30,000	Quarterly
Marvelous Fund NV	10.1	450,000	(24,000)	4,500	0	Semi-Annual
Other funds:	10.8	480,485	18,221	5,500	3,500	Monthly-Annually
Subtotal	32.1	1,430,485	139,221	$15,200	$33,500	
Carron Int'l Fund	10.7	475,000	118,000	*	*	Monthly
Total	42.8%	$1,905,485	$257,221			

* = The fund operator is not able to obtain the specific fee amounts for this fund and does not know what those amounts are. However, management fees are computed based on 1% per year of net asset balances at the beginning of each month; incentive fees are computed based on 20% per year of net income.